Research Department
Federal Reserve
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February 29, 1980

FRB SF Weekly Letter

Monetary Aggregates—Redefined

Monetary aggregates play an important role in the Federal Reserve's control of monetary policy, because of their strong empirical association with the goals of monetary policy: full employment, stable prices, and a stable exchange value of the dollar. Over the past decade, the Federal Open Market Committee (FOMC) has formally incorporated money-growth rates into its policy directives. And in recent years, Congress has required that such objectives be established, first in Joint Resolution 133 of 1975, and then in the Full Employment and Balanced Growth Act of 1978 (the "Humphrey-Hawkins Act").

Consequently, since 1975, the FOMC has provided Congress with longer-run target ranges, covering one-year periods, for several major monetary aggregates. (Currently, at the FOMC's February meeting, the committee establishes ranges extending from the fourth quarter of the preceding year to the fourth quarter of the current year.) But which aggregates are most important for the Fed's purposes? In our rapidly changing financial environment, the measures that are relevant today are not always relevant tomorrow. This situation creates pressure on the Federal Reserve to refine and redefine its measures, in line with certain analytical principles—hence the need for the redefined measures which the Fed unveiled earlier this month.

Shifting guidelines

Previously, in constructing monetary aggregates, the Federal Reserve followed the guiding principle that considerable differences existed between the deposits issued by commercial banks and those issued by thrift institutions (savings-and-loan associations, mutual savings banks and credit unions). M-1, as a measure of transactions balances, thus included only currency and commercial-bank demand deposits. Even the broader M-2 measure excluded thrift-institution deposits; specifically, it included currency plus all commercial-bank deposits except large negotiable time certificates at weekly reporting banks. Thrift-institution deposits were included only in M-3, the broadest targeted aggregate.

Today, because of the numerous regulatory and institutional changes of the past decade, the Fed has adopted a different guiding principle which recognizes the increasing similarity of bank and thrift-institution deposits. Thus the Fed constructed new definitions—called M-1B, M-2 and M-3—by aggregating particular types of bank deposits with similar thrift-institution deposits (See chart for definitions and data). In addition to these aggregates, the Fed constructed an aggregate (called M-1A), which is the same as the previous M-1 except for the exclusion of certain foreign-held deposits, and another aggregate (called L) as a very broad measure of liquidity.

Regulatory changes

In the regulatory area, the most important change was the development of checking-type deposits (some interest-bearing) across institutional lines. In recent years, various regulatory authorities have authorized NOW accounts (Negotiable Orders of Withdrawal) at banks and thrift institutions, share drafts at credit unions, ATS accounts (Automatic Transfer Savings) at commercial banks, and demand deposits at certain thrifts in the Eastern United States. In other words, many thrift institutions now issue transactions deposits resembling the demand deposits previously issued only by banks.

Other regulatory changes provided for pre-authorized savings transfers at banks and thrifts, telephone transfers of commercial-bank savings balances, point of sale (POS) automated-teller terminals permitting remote savings-deposit withdrawals at savings-and-loan associations, and government- and business-savings deposits at commercial

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banks. These new regulations all have enhanced the liquidity of a significant portion of the savings deposits held by commercial banks and thrift institutions. Consequently, these deposits have taken on many of the characteristics of bank-held transactions balances.

Moreover, regulatory authorities authorized commercial banks, savings banks and S&L's to issue six-month money-market certificates (MMCs) in June 1978, and thus blurred the distinction between the time deposits of these types of depository institutions. Such deposits, with ceiling rates tied to the six-month Treasury-bill auction rate, have become a major source of funds for banks and thrifts ever since their authorization. In 1979, for example, bank MMCs quadrupled in volume during the year, reaching $265 billion, and thus offsetting an outflow of fixed-ceiling savings deposits.

Financial innovations

Certain financial-market innovations have also necessitated new definitions of the monetary aggregates. Money-market mutual funds, for example, offer investors liquidity, high rates of return (comparable to open-market rates), and also a check-writing privilege (in minimum denominations). These funds behave like both transactions balances and short-term savings deposits, and so have become a popular alternative to low-yielding bank and thrift-institution deposits.

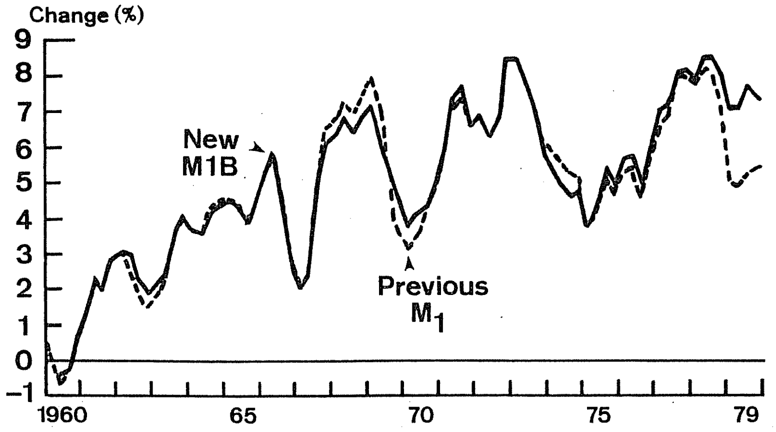
In another market innovation, large corporations have developed sophisticated cash-management techniques which permit funds that would otherwise languish in low-interest-bearing savings accounts or in non-interest-bearing checking accounts to earn market rates of return. One such technique involves overnight repurchase agreements— transactions where a financial institution sells a security to a customer (such as a corporation, state or local government, or broker-dealer firm) and agrees to repurchase the security at a specific price and future date. A second technique involves Eurodollar deposits, which are denominated in U.S. dollars and held by U.S. nonbank residents at U.S. banks' foreign branches. Banks then borrow these funds from their foreign branches for domestic use. (Because of data-availability problems, only deposits held at Caribbean branches could be included.)

With better definitions which more closely reflect the market realities of the 1980's, the monetary aggregates will more accurately indicate the current and future condition of the economy, and hence will help the Federal Reserve to devise policies to promote the goal of non-inflationary growth. Yet, while the redefined aggregates will be more useful than the previous definitions, the new measures are not without problems.

In particular, historical data on the new aggregates may not provide a good indication of how these aggregates will change over future business cycles. This problem arises because the new measures include deposit and non-deposit instruments which did not even exist prior to the past few years. Good examples are the *interest-bearing* checking accounts included in M-1A and M-1B (as well as the broader aggregates), and the money-market certificates included in M-2 and M-3. Unfortunately, this is an unavoidable problem in conducting monetary policy in a changing financial system.

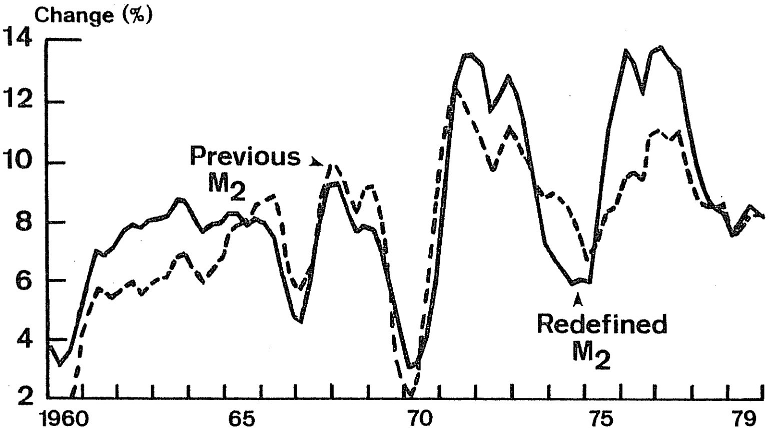
Under these circumstances, the Federal Reserve has responded by appropriately redefining its monetary aggregates to reflect an important trend in the U.S. financial system—the growing similarity of bank and non-bank depository institutions.

John P. Judd and Gary C. Zimmerman

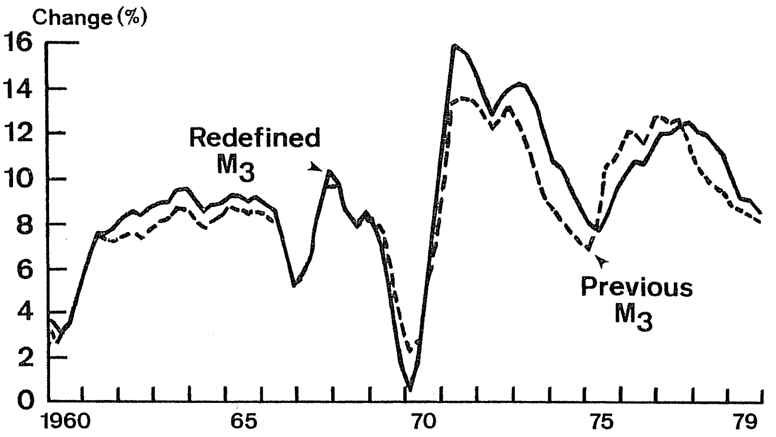


M1A = Currency
+ Adjusted demand deposits at commercial banks
− Demand deposits of foreign commercial banks and official institutions

M1B = M1A
+ Other checkable deposits (includes NOW accounts, ATS accounts, share draft balances at credit unions, demand deposits at thrift institutions)



M2 = M1B
+ Savings deposits at commercial banks
+ Savings deposits at all other depository institutions
+ Small denomination (less than $100,000) time deposits at commercial banks
+ Small denomination time deposits at all other depository institutions
+ Money market mutual fund shares
+ Overnight repurchase agreements (RP's) issued by commercial banks
+ Overnight Eurodollar deposits at Caribbean branches of U.S. commercial banks
− M2 consolidation component



M3 = M2
+ Large denomination ($100,000 and over) time deposits at commercial banks
+ Large denomination time deposits at all other depository institutions
+ Term RP's issued by commercial banks
+ Term RP's issued by savings and loans

Note: Data are year-to-year percent changes

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 2/13/80	Change from 2/6/80	Change from year ago Dollar	Percent
Loans (gross, adjusted) and investments*	138,184	+ 403	+ 17,559	+ 14.56
Loans (gross, adjusted) — total#	115,729	+ 405	+ 17,186	+ 17.44
Commercial and industrial	33,425	+ 75	+ 4,412	+ 15.21
Real estate	44,459	+ 170	+ 8,779	+ 24.60
Loans to individuals	24,439	+ 24	+ 3,881	+ 18.89
Securities loans	1,431	+ 58	− 176	− 10.95
U.S. Treasury securities*	6,964	− 16	− 667	− 8.74
Other securities*	15,491	+ 14	+ 1,040	+ 7.20
Demand deposits — total#	43,739	−1,112	+ 3,777	+ 9.45
Demand deposits — adjusted	31,289	− 655	+ 1,309	+ 4.37
Savings deposits — total	28,132	− 146	− 1,627	− 5.47
Time deposits — total#	59,342	+ 394	+ 8,285	+ 16.23
Individuals, part. & corp.	50,647	+ 465	+ 9,175	+ 22.12
(Large negotiable CD's)	21,339	+ 228	+ 2,492	+ 13.22

Weekly Averages of Daily Figures	Week ended 2/13/80	Week ended 2/6/80	Comparable year-ago period
Member Bank Reserve Position			
Excess Reserves (+)/Deficiency (−)	− 23	− 13	23
Borrowings	181	19	64
Net free reserves (+)/Net borrowed(−)	− 205	− 32	− 41
Federal Funds — Seven Large Banks			
Net interbank transactions [Purchases (+)/Sales (−)]	+2,212	+3,723	+ 637
Net, U.S. Securities dealer transactions [Loans (+)/Borrowings (−)]	− 59	+ 69	+ 422

* Excludes trading account securities.
# Includes items not shown separately.

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